To: Debt, Equity, and Capital Tax Reform Working Group
From: Small Business Investor Alliance
Date: April 12, 2013

On behalf of the Small Business Investor Alliance[1] (SBIA), we commend the committee on its approach to tax reform by forming working groups to review current law and to compile feedback from the public. We appreciate the opportunity to make comments to the Debt, Equity, and Capital Tax Reform Working Group.

As the committee discusses and makes comprehensive changes to the tax code, we urge you to look carefully at how new tax rules will impact capital investments in America's small businesses. SBIA supports the efforts of the Ways and Means Committee to reduce tax rates and simplify the tax code and we encourage you to prioritize drafting a stable tax code that encourages investment in small businesses. Small businesses employ half of the workforce and small firms accounted for 67 percent of the net new jobs since the latest recession, from mid-2009 to 2011,[2] and the best way to generate the most jobs is to promote smart tax policy that supports investment in small businesses.

Small private equity funds that make debt and equity investments in small businesses are a very important component of small business financing. Scale matters in small business investing because the smaller the private equity fund, the more likely it is to invest in smaller businesses. Small funds deploy capital in sizes smaller companies can absorb and use to grow. Smaller funds seek to build a diversified portfolio of investments, so the manager of a $100 million fund would typically seek to allocate those funds to 15 or 20 investments in different firms.

Smaller funds invest in smaller businesses because they are experts at growing companies, which is not always the goal of investing in large companies. Small businesses may be too risky to access bank loans, but private capital is more patient and capable of handling the risk of

[1] The Small Business Investor Alliance (www.sbia.org) is the premier organization of lower middle market private equity funds and investors. Our members provide capital to small and medium sized businesses nationwide, resulting in economic growth and job creation.
[2] Bureau of Labor Statistics: www.bls.gov/bdm

smaller businesses. Small businesses cannot access public markets to access long term capital. Smaller private equity funds fit their needs by providing access to private long-term debt and equity capital, which is essential to growing and creating jobs.

Small businesses that are backed by private equity have an undeniable impact on job creation and revenue growth. According to a 2012 Pepperdine University study, over a five year period after a financing event, private equity backed establishments generated 129 percent more revenue growth and 257 percent more employment growth than their non-private equity backed counterparts.[3]

Small private equity funds are fundamental to creating value in their portfolio companies. Small private equity funds don't just provide capital to small businesses and sit on the sidelines and hope they grow. Following the investment, private equity fund managers work closely with a company's management team on many specific aspects to accelerate the company's growth. Private equity fund managers are active participants at every stage of business development to help vibrant and motivated entrepreneurs grow their companies to support local communities.

Fund managers work to improve the profitability by developing better products and services, expanding the sales channels, and introducing the portfolio companies to new supply chains. Fund managers work with the CFOs of their portfolio companies to improve financial operations and IT systems, reduce costs, and streamline financial reporting processes. Private equity invests for the long term, and during market and financial crises, the patient capital of private equity funds can help businesses survive a downturn or economic shock.

We encourage the Debt, Equity, and Capital Tax Reform Working Group to focus on the following components of the tax code to ensure that their efforts on tax reform encourage investment in small businesses: 1) lower capital gains rates; 2) encourage investments in qualified small businesses; 3) maintain interest on debt deductibility; and 4) maintain the tax treatment of carried interest.

Capital Gains Taxes

The capital gains rate is currently too high. The American Taxpayer Relief Act, effective on January 2, 1013, made permanent three tax brackets for capital gains and dividends. The maximum statutory capital gains rate set is at 20% and the scheduled "Pease limitation" on itemized deductions imposes an additional 0.9% marginal rate on capital gains. In addition, Section 1411 of the Patient Protection and Affordable Care Act (PPACA), effective on January 1,

[3] Paglia, John and Maretno Harjoto. "Did They Build That? The Role of Private Equity and Venture Capital in Small and Medium Sized Businesses." Graziado School of Business and Management, Pepperdine University, http://bschool.pepperdine.edu/newsroom/wp-content/uploads/2012/12/Paglia-Harjoto-PE-VC-11.29.2012-IEGC.pdf

2013, imposes a new payroll tax on "investment income" which includes capital gains. This tax provision – which also applies to dividends, rents, and royalties – is a new 3.8% Medicare tax on investment income for couples earning more than $250,000 ($200,000 for single filers).

Combining the top statutory capital gains rate with the Pease limitation and the new payroll tax on investment income makes the top combined rate almost 25%. This is an enormous new cost for small business investors because they will now pay a staggering $25 to the taxman for every $100 in profit, which is $10 more than last year. For investors that reinvest their after-tax profits, they will now have 67% less to invest in small businesses.

It is important to look at history to remind us of the impact that high capital gains rates have on our economy. Historically, increases in the capital gains rate led not only to reductions in revenues to the Treasury but also to reductions in the ability of private equity firms to attract new commitments. According to IRS data on revenue generated from capital gains taxes, the amount of revenues brought into the Treasury from capital gains is inversely related to the top capital gains rate. During the four year period before the Tax Reform Act of 1986 was enacted (Tax Years 1983-1986), when the top capital gains rate was 20%, the Treasury brought in an average of $11.7 billion in capital gains tax revenues. Conversely, during the four year period after the Tax Reform Act of 1986 (Tax Years 1987-1990), when the top capital gains rate bounced as high as 28%, the Treasury brought in an average of $8.1 billion in capital gains tax revenues. There is a clear difference between the revenue generated from a higher tax on capital gains versus a lower tax.

The increase in the top capital gains rate to 28% from 20% starting in 1987 may have negatively impacted new commitments to private equity firms. During the mid-1980s, new commitments to private equity partnerships trickled up each year from around $2 billion in 1984 to over $14 billion by 1987. However, new commitments to private equity declined by 27% the following year (1988) and were cut by 67% by 1990. Commitments slowly recovered back to the 1987 level by 1997[4], almost ten years after the top capital gains rate was increased from 20% to 28%.

We recommend repealing the new surtax on investment income, repealing the Pease limitation, and reducing the statutory capital gains rate to encourage investment in Main Street businesses. These changes would show investors that Congress values their role in the economy. At a minimum, we encourage the Committee to look closely at encouraging investment in qualified small businesses, which is covered in the next section.

---

[4] Stephen N. Kaplan, Private Equity Analyst, *Commitments to Private Equity Partnerships.* University of Chicago Booth School of Business.

Qualified Small Business Investment

One way that the Committee can strengthen its commitment to small businesses is to encourage direct capital investments in certain business entities defined as a qualified small business (QSB). SBIA recommends the Committee make changes to the 1202 QSB definition, which was extended by Congress recently to allow for a temporary 100% exclusion from gross income of gain derived from QSB stock held for more than five years.

With certain adjustments to the QSB provision, the Committee can encourage short- and long-term investments in businesses that depend on early-stage and growth capital to excel. SBIA recommends making a number of changes to the law that would modernize and simplify the QSB provision.

The current definition of QSB is based on an active business test and an aggregate gross assets (under $50 million) test. Additionally, the definition only applies to C-corporation stock investments held for more than five years. There are also industry limitations (hotels and oil and gas businesses are not eligible) and confusing limitations on the amount of portfolio stock and real estate that an eligible corporation can hold. Taken together, these limitations make it more difficult for the investor to identify eligible investments.

SBIA recommends changing the definition of QSB to include all equity and debt investments made directly in a qualified small business that is considered a "small business concern" as such term is defined pursuant to Section 3(a) of the Small Business Act (15 U.S.C. 632(a)). This definition is recognized throughout the investment community and is used by the Small Business Administration's Small Business Investment Company (SBIC) program as a way to determine investment eligibility.

Modernizing the definition would simplify the tax code substantially because taxpayers would be in a better position to prove that their investments meet the QSB eligibility test. The simplified provision would make it easier for the IRS to administer the provision because they can rely on a modernized approach to proving that a QSB is in fact eligible. It is much easier for a taxpayer to prove eligibility based on a gross income test rather than an assets test. The current assets test may require annual valuations to prove to the IRS the QSB's assets are not above the gross assets limitations. An eligibility test that relies on gross income is much easier to prove because the QSB is already providing that information to the IRS on their annual tax return.

We recommend ensuring that all direct investments in a QSB, whether they are debt or equity, or a blend of the two, are incentivized. For example, an investor that provides vital capital in the form of debt to a QSB should be encouraged to do so through a reduction in their ordinary income taxes. Just the same, an investor should be encouraged to hold equity in a privately held company through a reduction in any capital gains they pay to the IRS.

With regard to eligible equity investments, the Committee should change the holding period to three years or more, rather than the current five-year holding period. The current five year holding period might artificially hold certain investors back from exiting a portfolio company. It is very common for a private equity investor in a privately held company to sell their stake after only three years. It may only take three years for the private equity fund to build value in the company and sell to a bidder that can add value differently for the private company.

The changes described above would be a valuable way to show small business investors that their investments are the ones that are most important to job creation and economic growth. As we already stated, small businesses play a special role in job creation, and it makes sense to target new investment in that direction through smart tax policy.

Interest on Debt Deductibility

We encourage the committee to maintain interest on debt as an ordinary business expense because businesses rely on debt to finance their operations and grow. Debt is a fundamental part of a typical company's capital structure and is often used to finance business activities like meeting payroll, buying raw materials, making capital expenditures, and acquiring new business ventures.

According to an NFIB survey on Small Business Credit Access, the most frequent purpose for attempting to borrow is to support cash flow (63%). Those attempting to borrow for investments in plant, equipment or vehicles totaled 37% and those attempting to borrow to invest in inventory totaled 38%.[5] This NFIB study proves that debt financing is critical to having cash on hand to support, invest, and grow business operations.

Companies looking to finance investment with debt undergo rigorous due diligence from their creditors, and this due diligence pays off because it is a process that weeds out bad investments and helps ensure against default. Small business investors invest long-term patient capital to provide the best opportunity and flexibility for the company to grow and create jobs.

The tax code treats interest on debt as an ordinary business expense that is fully deductible from a company's taxable income. Interest is incurred in the ordinary course of a trade or business, and it should continue to be treated the same as any other ordinary business expense for tax purposes. It is also worth noting that allowing the deduction of interest aligns the tax code with generally accepted accounting principles (GAAP) accounting.

---

[5] William J. Dennis, Jr. NFIB Research Foundation. Small Business, Credit Access, and a Lingering Recession, January 2012. http://www.nfib.com/Portals/0/PDF/AllUsers/research/studies/small-business-credit-study-nfib-2012.pdf

Placing limits on the deductibility of business interest would harm U.S. investment and have an adverse effect on financing business activities. Limiting the deductibility of interest would penalize the growth of smaller or more dynamic companies that are reliant upon external financing to manage cash flow, innovate, expand and create jobs.

A study by Ernst & Young LLP found that limiting the deductibility of corporate interest would increase the tax cost of investing by substantially more than corresponding reduction in the corporate tax rate. The higher cost of investments from limiting interest deductibility, even with a revenue neutral reduction in corporate tax rates, would hamper U.S. investment. The Ernst & Young LLP study also found that by lowering the corporate income tax rate, the deductibility of interest expenses would increase the marginal effective tax rate on new corporate investment from 31.0 percent to 33.1 percent – a 6.7% increase in the marginal effective tax rate.[6]

<u>Carried Interest</u>

Private equity funds pool the capital of investors and invest this capital into venture and growth companies. Managers of these funds typically receive an annual management fee of 2 percent of the fund's committed capital and eligibility for a 20 percent share in the profits of the fund. The 20 percent profit sharing interest is referred to as the "carried interest." In most cases, the carried interest is not realized for fund managers until near the end of the 10+ year lifecycle of the fund. Because fund managers must successfully surpass a minimum profit target or "hurdle rate" (i.e. 8%) the realization of "carried interest" is generally not guaranteed.

Upon receipt of the carried interest, the fund manager gains interest in the fund and pays tax in the same manner as other partners (investors) on their distributive share of the fund's taxable income. The character of the income included in the manager's distributive share is the same as the character of the income recognized by the fund.

Thus, if the fund earns ordinary, dividends, or capital gain investment income, each partner's distributive share includes a portion of that income. For example, if the fund sells stock of a portfolio company, the manager's share of the long-term capital gain is taxed at the 20-percent federal long-term capital gain rate.

Fund managers must wait years to receive a benefit from owning the carried interest if they are sharing in the success of their investors. Almost 90% of a small business investor's capital gains

[6] Drs. Robert Carroll and Thomas Neubig, Ernst & Young LLP. *Business Tax Reform and the Tax Treatment of Debt: Revenue Neutral Rate Reduction Financed by an Across-The-Board Interest Deduction Limit Would Deter Investment*. May 2012.

income comes from the carried interest after 10 years of risk successfully growing small businesses. Current tax law aligns the interests of the fund managers and those of the capital investors, which leads to more successful deals and better value creation in portfolio companies. Changing the tax treatment of carried interest would distort the economic interests between the fund managers and the outside capital investors, leading to an elimination of the alignment that has resulted in successful deals and better value creation for domestic small businesses.

A partner's share of income is subject to the entrepreneurial risks of the partnership's business. Any changes to carried interest would reverse longstanding tax rules that determine the character of a partner's distributive share of partnership income.

Policy makers should encourage the pooling of capital, ideas and skills in a manner that promotes entrepreneurship and risk-taking. Pooling capital increases the amount of capital available for small businesses. Changing the tax treatment of carried interest would reduce incentives for fund managers to hold long-term equity investments in job creating small businesses, which would dampen risk-taking and entrepreneurship.

The Committee should be mindful of the disproportionate impact changing carried interest rules will have on smaller private equity funds. The smaller the fund, the less it will be able to withstand an increase in the tax rate for carried interest because smaller funds cannot survive solely on asset-based management fees. For smaller funds, asset-based management fees are too small to maintain top fund managers so they depend upon the performance-based business model to retain top small business investors for the 10+ years of the fund lifecycle. For smaller funds, if the carried interest tax rate increases dramatically, it makes less sense economically to be able to sustain a fund. Therefore, the only way for a small fund to survive will be to become a very large fund that can survive on asset-based management fees – fees which are completely disconnected from performance.

With all these points made, if the Committee decides to reduce the ordinary rate to the same level as the capital gains rate, the impetus for carried interest disappears. Should the Committee take this approach, we highly recommend the Committee encourage investment in small businesses by modifying the current tax provision for qualified small business investments.

We appreciate your commitment to tax reform during the 113th Congress, and look forward to working with you to draft smart tax policy that prioritizes job creation and small business investment. Please contact us at any time to discuss this comment letter in more detail. Thank you again for allowing an open process to hear from the public on tax reform.

Please contact Chris Walters at [redacted] to set up a time to discuss any of the issues presented in this document.

Sincerely,

Brett Palmer
President
Small Business Investor Alliance